Setanta Global Equity Fund (USD) – Q2 2017

Setanta
ASSET MANAGEMENT

Fund Description

The **Global Equity Fund** ('the Fund') is managed by Setanta Asset Management Limited ("Setanta") and is a representative account of the Global Equity strategy.

The Fund is a diversified, actively managed equity portfolio. As bottom-up fundamental value investors, our research process is designed to properly understand how each business functions and to consider risks pertinent to the business. Securities are chosen by a team of global sector specialists, targeting sensible diversification across industries, geographies and market capitalizations. We value each business, with the priority to pay a price that mitigates downside risk. We aim to make investments for the long-term, all the while considering the available opportunity set.

Fund Commentary

The market value of the Global Equity Fund gained by 11.5% (gross of fees, USD-terms) in the year-to-end June 2017 (0.8% ahead of the 10.7% benchmark MSCI World in the period). These returns are very healthy in US dollar terms but in Euro terms they were a little skinnier, but it must be seen in the context of the even skinnier returns currently on offer from other asset classes, especially in bonds; for example, German 10-year bonds yielded less than 0.5% at the time of writing. This is causing investors to take on unusual risks in the search for additional return. This was highlighted in June, when the "bad boys" of the government bond market, Argentina, issued a $2.75bn US dollar-denominated 100 year bond yielding 8%. If history is any guide, this bond will have been defaulted on four times before the principal is due to be paid (i.e. good luck with that!). To our minds, a mere 8% seems grossly inadequate compensation to investors. Amazingly, the issue was in high demand, three-and-a-half times oversubscribed. In that light, we are highly confident in the 100-year prospects of the fund.

(Fund Commentary continued on Page 3)

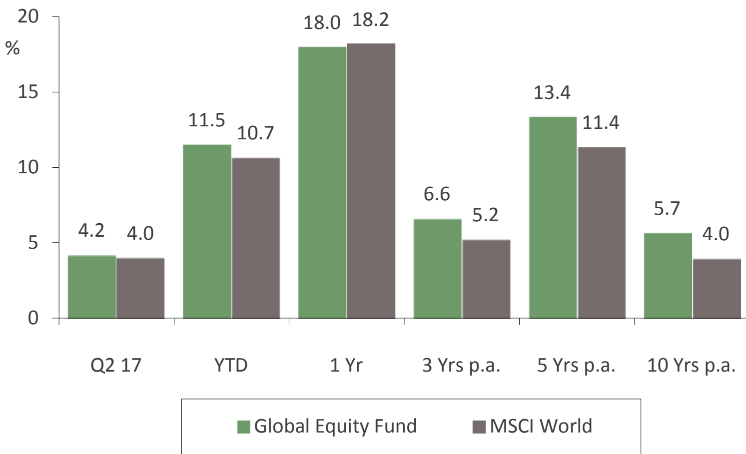
Portfolio Managers

David Coyne & Sean Kenzie

Investment Principles

- We do not believe the market is efficient.
- We aim to make investments at a price below our assessment of intrinsic value.
- We make an investment in a business rather than trade securities.
- We believe risk is the possibility of permanent impairment of value.
- We make investments for the long term.
- We invest where we see value and are not afraid to be contrarian and swim against the tide.
- We don't make forecasts, we consider scenarios.
- We demand financial strength from the companies we invest in.
- We will act with integrity and communicate with our clients in a manner representative of our investment style.
- We have the humility to know we make mistakes and embrace the need to continue learning through both experience and study.

FUND PERFORMANCE – 30.06.17

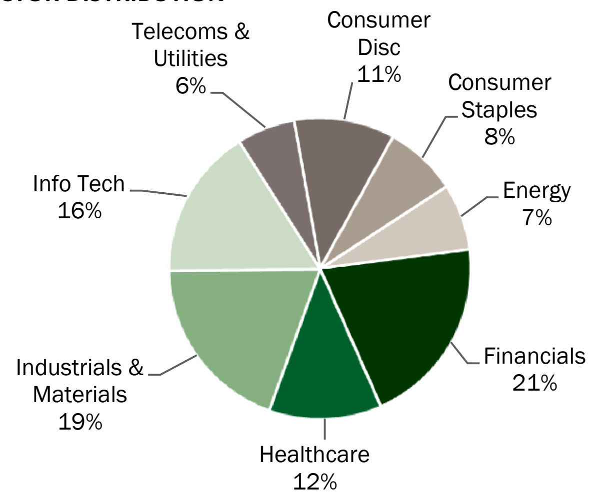


Performance Source: Unit prices: ILA converted to USD at FX Rate 1.1406. Benchmark: MSCI World (USD). The Fund returns, in USD, stated are based on the movements in the unit prices of a representative account, based on mid to mid prices, and are gross of management fees. The performance will be reduced by the impact of management fees paid, the amount of which varies. **Fund Statistics Source:** Bloomberg

FUND STATISTICS

PRICE/BOOK	2.1
PRICE/EARNINGS RATIO (FY 1)	17.7
DIVIDEND YIELD %	1.9
AVERAGE MARKET CAP $BN	60.7
NO. OF HOLDINGS	89
ACTIVE SHARE %	88.3
DEBT/EQUITY %	56.1

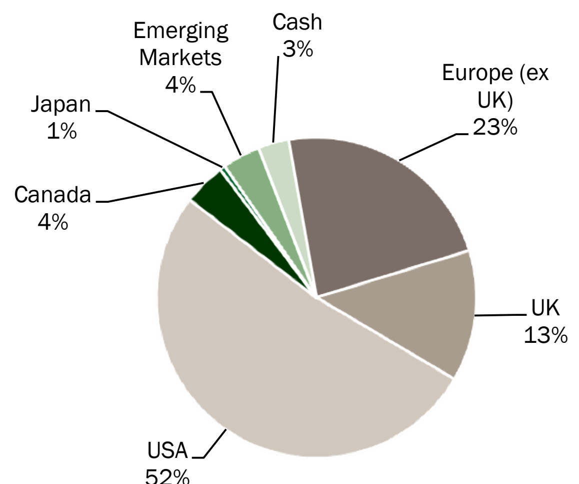
SECTOR DISTRIBUTION



TOP 10 HOLDINGS

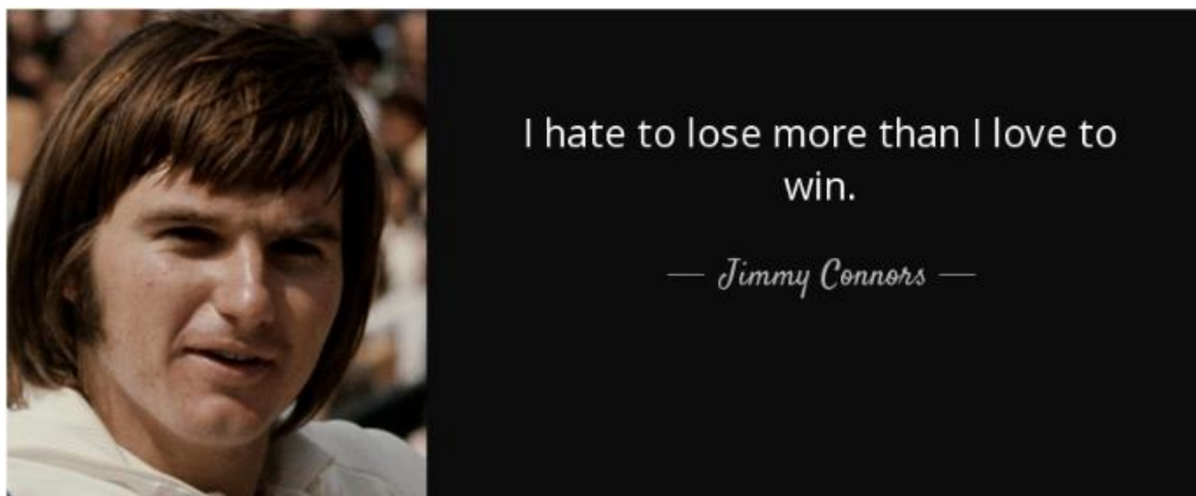
COMPANY	SECTOR	% OF FUND
OWENS-ILLINOIS	INDUSTRIALS & MATERIALS	3.6%
DCC	INDUSTRIALS & MATERIALS	3.3%
BERKSHIRE HATHAWAY	FINANCIALS	3.0%
CRH	INDUSTRIALS & MATERIALS	2.9%
LEUCADIA NATIONAL	FINANCIALS	2.8%
OSHKOSH	INDUSTRIALS & MATERIALS	2.5%
JOHNSON & JOHNSON	HEALTHCARE	2.2%
FEDERATED INVESTORS	FINANCIALS	2.2%
SAMSUNG ELECTRONIC	INFORMATION TECHNOLOGY	2.1%
MICROSOFT	INFORMATION TECHNOLOGY	2.1%

GEOGRAPHIC DISTRIBUTION



YEARLY PERFORMANCE

Year %	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Fund	39.8	19.5	10.8	26.3	9.8	-39.7	36.4	8.7	-2.4	15.9	30.2	5.9	-2.2	12.8
Benchmark	33.1	14.7	9.5	20.1	9.0	-40.7	30.0	11.8	-5.5	15.8	26.7	4.9	-0.9	7.5
Relative Performance	+6.7	+4.8	+1.3	+6.2	+0.8	+1.0	+6.4	-3.1	+3.2	+0.1	+3.5	+1.0	-1.3	+5.3



“Hate to lose”

Jimmy Connors is a retired tennis player, considered among the greatest in the sport’s history. He won 8 majors over his 24 year career (1972-1996). He had a career win-loss ratio of 81.8%, the 4th best record in the history of the game. His achievement is made all the more remarkable by the sheer number of games he played: 1,535 pro singles matches (an open-era men’s record), which is at least 50% more games than the three players ahead of him in the win-loss ratio table. In short, Connors was a winner.

However, Connors’ famous quote – “I hate to lose more than I like to win” – seems almost the opposite of a winner: his driving force was a fear of failure. At first glance, it almost seems sad. I have news for you: we all hate losing. Cognitive psychologists, who study how our brains process and perceive things, have coined the term “loss aversion” to explain people’s tendency to prefer avoiding losses to acquiring equivalent gains.

The process of avoiding losses fits squarely in the Setanta way of managing money. First and foremost, we obsess about how our investments can go wrong and place far less emphasis on the upside. It’s a process that has served us well in our 19 years being in business. If this investment mind-set tallies with yours, we suggest you keep reading.

Four-step investment research process

A question we are frequently asked is: How do you choose investments from the tens of thousands of publically-quoted stocks in the world? For us it’s a four step process that, at a quick glance, probably sounds undifferentiated from what the uninspired herd does. However, we believe there are key differences that give us a strong platform off which we apply our “hate to lose” mind-set.

The **first step** is to identify our target universe. We are constantly scouring the world for good quality companies that – on the face of it – exhibit certain business and management characteristics. We think that by filtering by business quality first (and not static valuation metrics), it helps us avoid “value traps” that drag down many of our fellow fund managers. Companies that interest us are ones where the business appears to have some competitive advantages; that are likely to endure (think decades); that are financially strong; that are run for the long-term by shareholder-friendly managements; that will tend to do well in a variety of operating environments. Companies that tick some or all these boxes proceed onwards.

The **second step** is the research effort: do the stocks from step one stand up to serious scrutiny? We pride ourselves on the depth of the research we carry out, a key differentiator compared to many of our peers. It is a diligent and labour intensive process, taking us months from start to finish. The work is all done in-house by Setanta’s portfolio managers. Our goal is to try to disprove the thesis that it is a quality company (“hate to lose”). We pore over the details in past annual reports, as the past very often gives significant clues to the future.

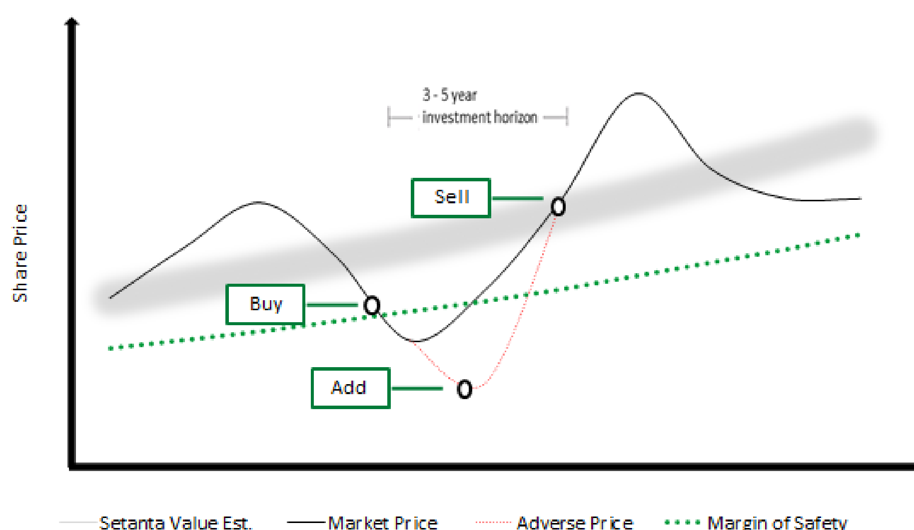
We read a variety of materials to gain an understanding of the industry's long term prospects and the position of the company in that context. We may speak with company management, competitor companies and leading industry experts. We pay particular attention to management and try to understand their motivations, especially regarding allocating capital, as many company CEOs are all too easily swayed by the short-termist whispers of Wall Street.

In the **third step**, a research note is written up and is disseminated to the investment team for discussion. There are two fundamental ground rules here and they are taken very seriously. The first is the obligation to present a 'warts and all' analysis of the investment. The second is that the investment team plays the role of devil's advocate, trying to pick holes in the thesis. This third step is critical in our aim to avoid losses ("hate to lose"). New perspectives and questions always arise from the process, which prompts further digging. It also serves to ferret out any inconsistencies in logic and to correct for biases in the investment case.

If the investment thesis is still intact after steps one-to-three, the **fourth step** involves ensuring we are not paying too high a price, otherwise we put ourselves on a path to mediocre returns ("hate to lose"). Waiting to buy at the right price can at times require the patience of Job – again, not something the investment industry is known for. Sometimes our patience must endure years.

The chart below aims to graphically illustrate how we think about our buy and sell decisions. The fuzzy grey line is our estimate of a company's fundamental value. It slopes upwards because quality companies tend to become more valuable over time. Its fuzziness is a humble acknowledgment that the future is uncertain and that precise estimates are not feasible. The solid black line is the share price, which will tend to oscillate around the true worth of the company, as investors fall in and out of love with it. The dotted green line is the level below which we are looking to buy i.e. a material discount to what we think the company is worth; the red-dotted line shows an alternative pathway for the share price and highlights that we will likely buy more shares at lower prices, so long as our estimate of its value hasn't changed. If our analysis is correct, economic forces should eventually nudge the share price towards fair value, a process that can take years, at which point we may look to sell. However, the sell decision will depend on many factors, including the valuation of alternatives, which may lead us to hold on longer. Indeed, we strongly suspect that there is a systemic undervaluation of the types of quality companies we seek, which investors assume revert to being mediocre before time, and this can lead to a prolonged catching up of the share price with a company's true value.

Long-Term Investors, Short-Term Opportunists



Being long-term means exactly that: over 60% of the current Global Equity fund has been held for 5 years or more and some stocks have been held since the fund inception in June 2000. At the same time, we need to be short-term opportunists, ever ready to capitalise on situations that we know well and we feel we are being over-compensated for the risks being assumed.

A related point is that we cannot control how investors perceive our investments over the short term. The market value of the Global Equity fund fell in 4 years out of its 16 year history, including the painful declines of 2002 (-29%) and 2008 (-37%). However, those declines did not reflect fundamental values of the businesses held by the fund (evidenced by the strong rebound in market values in subsequent years). So when we apply our "hate to lose" mind-set, it is in the context of failing to properly analyse or value a business' long term fundamentals. Like Jimmy Connors, we get things wrong, the equivalent of losing games, sets and matches, but over the course of a season and a career, we are confident that our win-loss ratio will be among the best in the business.

Transactions in Q2:17

During the quarter we purchased two new stocks for the fund, both in the consumer discretionary sector, both of which went through the thorough four-step process outlined above. As consumers, many of you will know or have used their brands: Harley Davidson and The Priceline Group.

Harley Davidson

Harley Davidson makes and finances iconic, premium-priced motorcycles globally. Harley has a fantastically-loyal customer base that feels very much part of a family. Riders regularly socialise and ride with fellow Harley Owners Group ("HOG") members. Harley Davidson has a c.50% + market share of large cruiser and touring bikes in the US (its main market), with Honda its nearest competitor and there are only 5-6 credible competitors in total. The business generates very decent returns on capital and management is sound.

We have our concerns, as always. Front and centre is the risk that Harley's current aging rider population won't be replaced. Bike riding is significantly more dangerous than driving a car and today's youth are more interested in screen time than the open roads. Harley is aware of the problem of course and is putting a lot of effort in appealing to 20-35 year old riders through rider training programs and a range of cheaper (read: low margin) "street" bikes, which they hope will in time be upgraded to premium products. They are also looking to grow their appeal with women (c.10% of unit sales), as well as continuing to grow internationally (c.40% of unit sales). So we think there's a good chance that group volumes will be sustained or grow modestly in the decades to come.

Another concern is that the group's financing of customers to buy their bikes – particularly the subprime segment – could suffer in a tough economic environment. On this point we are comforted by history: Harley bikers are loathe to have their prized bike repossessed and, worst comes to worst, Harley bikes have tended to hold their values in the second hand market.

Thinking further about what can go wrong, we are conscious that Harley's are durable machines, more so than cars for example (as they are generally used for leisure riding as opposed to being a main mode of transport). Therefore if the bike riding population does decline over time, not only will new bike volumes be pressured but the stock of Harley bikes currently on the road will compete with new bikes and may even hurt the brand's premium pricing strategy. And if second-hand bike values fall, this will impact recovery rates on repossessed bikes. Understanding how these overlapping issues impact profitability is a highly complex problem. Our best guess is that volume declines, if they happen, will be very gradual and should allow the company plenty of breathing space to adjust their cost base to remain profitable.

In summary, we believe the market is likely paying insufficient attention to the company's quality factors in its current valuation and the downside in adverse scenarios should be manageable. However, in recognition of the risk we are wrong, we have made this stock a modest weighting in the fund for now.

The Priceline Group

We bought Priceline in Q2 2017 after monitoring the business for a long time. Priceline's main business is Booking.com, which is the world's leading Online Travel Agent or OTA. Booking.com is essentially a booking engine that enables people to book hotel rooms online. Booking.com has huge scale on the demand side and on the supply side. They may process in the region of 650m hotel nights this year. They currently have just over 1.3m properties listed on their website. This sort of scale helps them attract new hotel suppliers and helps maintain and grow their customer base as the Booking.com offering is improving all the time. The economics of the transaction are fairly simple: the customer pays the hotel in cash after they stay and the hotel pays Booking.com a 15% commission 30 days later. At a forward FCF/EV of almost 5%, if Priceline can grow room nights at double digits for the next 3-5 years this is an attractive proposition.

Priceline does most of its business with independent hotels that are very reliant on Booking.com for feeding them customers. However, they have a small but meaningful part of their business with chain hotels (think Marriott, Holiday Inn etc.). These chain hotels are actively trying to push more customers through their own direct channels by offering loyalty programmes and marketing directly more. If they are successful Booking.com may lose out. We think though a bigger threat could come from another platform building scale in the hotel booking transaction business. TripAdvisor has tried numerous times to get more involved in transactions. So far their efforts have not borne any fruit. A more worrying threat could come from Amazon, Google, Facebook, Airbnb or another software business that has yet to emerge. We will be monitoring these threats with a very close eye over the coming years.

David Coyne – Portfolio Manager

Contact Details:

Setanta Asset Management Limited,
Beresford Court,
Beresford Place, Dublin 1, Ireland.

Alan Hickey, Tel: + 353 1 612 4903
Email: alan.hickey@setanta-asset.com
www.setanta-asset.com

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